

Impact of COVID-19 on Financial Statements

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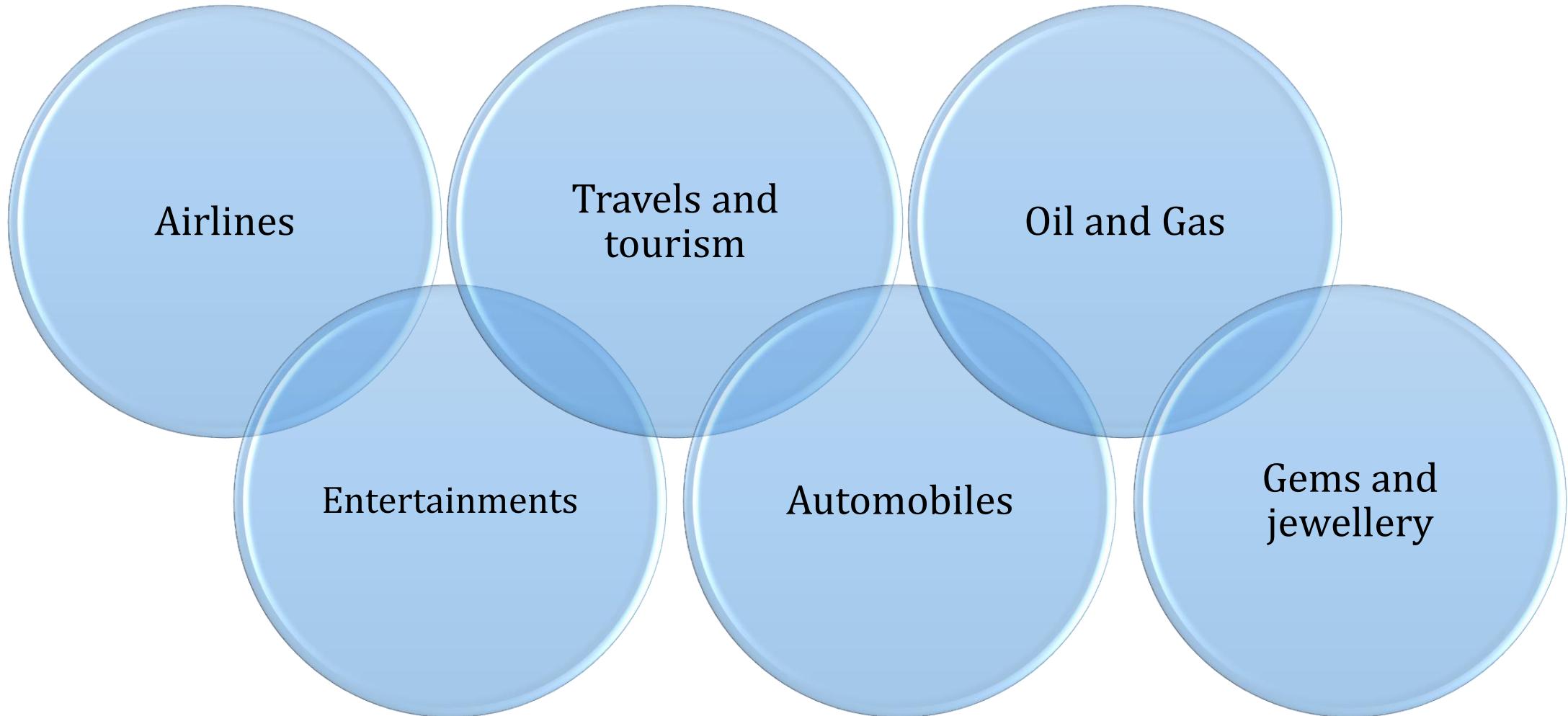
Areas to be considered

- Inventory measurement
- Impairment of non-financial assets
- Financial instruments
 - Impairment losses
 - Fair Value Measurement
 - Hedge Accounting
- Revenue
- Borrowing cost
- Leases
- Provisions, contingent liabilities and contingent assets
- Income tax
- Going concern

Areas of concern

- Demand (revenue, contract fulfilment)
- Supply chain (just-in-time inventory model, impairment)
- Working capital (cash flow management, debt covenant, liquidity)
- Cybersecurity (working from home, shut down of security monitoring centres)
- Onerous contract provisions
- Legal obligations (Contract terminations)
- Contractual penalties
- Business continuity planning

Severely impacted sectors



Ind-AS 2 / AS 2 - Inventory Measurement

- Inventories are measured based on cost or net realisable value, whichever lower
- Due to reduced movement, decline in selling price, inventory obsolescence, the management may consider written down value of inventories to NRV on item by item with appropriate disclosures
- Obtain item wise inventory valuation from an independent valuer
- Fixed overheads are allocated based on normal production capacity, due to reduced production, allocation of such overheads should not be increased.
- The fixed overheads allocated to each unit of production is not increased as the consequence of low production or idle plant

SA 501 – Specific considerations for selected items

- If physical inventory counting is conducted at a date other than the date of the financial statements, the auditor shall perform audit procedures to obtain audit evidence about whether changes in inventory between the count date and the date of the financial statements are properly recorded.
- If attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory.
- If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with SA 705.

Ind AS 36 / AS 28 - Impairment of Non-Financial Assets

- The entity, requires to assess, at the end of each reporting period, whether there is any indication that non-financial assets may be impaired. The impairment test only to be carried out if there are such indications. If indications exists, the entity shall estimate the recoverable amount of the assets.
- Ind AS 36 relies on an 'economic' criterion for the recognition of an impairment loss. Due to COVID-19, there might be temporary ceasing of operations or immediate decline in demand or price resulting in lowering of revenues, profitability and reduced economy activity These are the factors that the management may consider as the indicators that may require impairment testing.
- Reasonable assumptions should be taken into consideration while estimating the value in use and fair value less cost of disposal and ensure that the impairment loss is estimated reliably.
- Due to COVID-19, there might be an adverse impact on a CGU to which goodwill is allocated and hence impairment of goodwill will require additional focus and attention.
- Critical factors to consider :
 - ✓ Contraction in economic activity due to COVID19 is considered to be an impairment indicator at the reporting date for impairment assessment
 - ✓ The assumptions used to determine discount rate to measure the recoverable amount require any adjustments
 - ✓ Market assumptions used to determine fair value for recoverable amounts need reconsideration

Ind AS 109 – Financial Instruments

Expected Credit Loss

- Financial Instruments within the scope of Ind AS 109 such as Loans, Trade Receivables, Other Receivables, Investment in Debt instruments, Financial Guarantees and Loan Commitments not measured at fair value through profit or loss, Contract Assets and Lease Receivables are subject to impairment loss recognition and measurement based on an approach called Expected Credit Loss (ECL).
- ECL recognized based on segregation of credit exposures into 3 buckets viz. no significant increase in credit risk, those with significant increase in credit risk and Credit impaired.
- In case of certain financial assets such as Trade Receivables where the simplified approach is applicable, this segregation of credit exposures into 3 buckets is not required.
- Entities may need to disclose the impact of COVID-19 on various credit related aspects such as methods, assumptions and information used in estimating ECL, policies and procedures for valuing collaterals etc.
- If the entity is unable to assess the impact of COVID-19, the same should be disclosed appropriately.

Ind AS 109 – Financial Instruments

Fair Value Measurement

- Ind AS 113 recognizes the fact that there are different ways in which fair value is determined i.e. it can be based on observable market price (quoted price in an active market – Level 1) or application of valuation techniques (Level 2 and Level 3) as of the reporting date.
- The current market has developed significant volatility and decrease in volume of activity
- Preparers using valuation techniques may have to consider the impact of COVID-19 on various assumptions including discount rates, future cash flow, credit-spread/counter-party credit risk etc.
- In respect of financial assets, entities have to carefully consider the impact of COVID-19 on determination of fair value for valuation of investments classified as Current Investments.

Ind AS 109 – Financial Instruments

Hedge Accounting

- The standard permits a highly probable forecast transaction to be a qualifying hedged item.
- If entities have adopted cash-flow hedge accounting for certain forecasted transactions, they should assess whether the transaction still qualifies as a highly probable forecast transaction considering their business environment.
- Entities will need to assess any hedge ineffectiveness and record the impact of that in profit and loss.
- Estimate the fair value of derivatives, including paying special attention to underlying assumptions of derivatives, e.g., forward curve of interest rate, foreign currency, commodity etc.

AS 13 – Accounting for Investments

- Current Investments – Current Investments are investments which by their nature are readily realizable and are intended to be held for less than a year from the date when such investment is done
- Long-Term Investments – Long-term investments are investments other than the current investments, even though they might be freely marketable.
- Auditor needs to perform impairment testing at the end of the Financial year in order to correctly value the investments.
- In case long term investments are severely affected, they need to be brought down to their realizable values

Ind AS 116 / AS 10 - Property Plant and Equipment

- COVID 19 may have impacted the useful life and residual life of PPE, thus resulting in underutilisation of PPE.
- The standards require depreciation charge, even if the PPE remains idle
- AS 10 requires that the useful life and residual life of the PPE needs revision on annual basis, and hence, if expectations differ from previous estimates due to impact of COVID 19, we have to account for changes in the accounting estimates.

Ind AS 21 / AS 11 – Effects of changes in Foreign exchange rates

- Usually, all the foreign currency monetary items must be reported at the closing rate
- In scenarios where the closing rate might not exhibit with reasonable accuracy amount in the reporting currency which is expected to be realized, the monetary items must be reported in reporting currency at the value which is expected to be realized from, or needed to disburse, such monetary item at the balance sheet date.
- An entity may defer losses for long term monetary item in such cases, however, the auditor has to identify the nature, timing and extent of each case and provide true and fair view accordingly.

Ind AS 115 / AS 9 – Revenue from contracts

- Due to COVID-19, factors like increase in sales returns, decrease in volume discounts, higher price discounts etc. need to be considered in estimating the amount of revenue to be recognized.
- Ind AS 115 also requires disclosure of information that allows users to understand the nature, amount, timing and uncertainty of cash flows arising from revenue.
- Therefore, entities may have to consider disclosure about the impact of COVID-19 on entity's revenue.
- Entity may postpone recognition of revenue due to significant uncertainty in collection.
- A disclosure has to be made about the circumstances where such recognition has been postponed.

SA 500 – Audit Evidence

- Auditors should assess the nature, amount, timing and cash flows arising out of the revenue.
- There may be sales returns, decrease in volume discounts, etc. which need to be considered.
- Auditors should properly conduct vouching in order to detect backdated invoices, if any.

AS 16 – Borrowing Costs

- AS 16 states that capitalisation of interest is suspended when development of the asset is suspended. (For qualifying assets)
- The management has to consider this aspect while evaluating the impact of COVID 19

Ind AS 116 / AS 19 - Leases

- Due to COVID 19, there may be changes in lease arrangements or lessor may give some concession to the lessee with respect to lease payments, etc.
- Force majeure clauses in agreement
- Discount rate used to determine the present value of new lease liabilities may need to incorporate any risk associated with COVID-19.
- Any compensation by the Government would be accounted under AS 12 – Government grants and not deducted from lease amount.
- Such revised terms or concessions lead to modification of leases and entity has to determine whether any lease has become onerous.

Ind AS 12 / AS 22 – Accounting for taxes on Income

- COVID 19 may affect future profit and also reduce the amount of deferred tax liabilities
- Entities with deferred tax assets should reassess forecasted profits and the recoverability of deferred tax assets with necessary disclosures.
- They should also consider the additional uncertainty arising from COVID 19 and the steps taken by management to control it
- Management should disclose any significant judgements and estimates made in assessing the recoverability of deferred tax assets, in accordance with Ind AS 1

SA 240 – Auditor's responsibility relating to a Fraud

- The impact of COVID-19 on businesses could be very significant and could put pressures on management to meet performance targets or market expectations.
- This raises the risk of the likelihood of fraud in the financial statements to a higher level which requires the auditor to exercise a much higher degree of skepticism and carry out extended audit procedures to eliminate the possibility of fraud or material error in the financial statements.

Ind AS 37 / AS 29 - Provisions, Contingent Liabilities and Contingent Assets

- Ind AS 37 requires assets dedicated to a contract to be tested for impairment before a liability for onerous contract is recognised.
- Ind AS 37 does not permit provisions for future operating costs or future business recovery costs. However, Ind AS 37 requires that an entity should disclose the nature of the obligation and the expected timing of the outflow of economic benefits.
- There is a need for exercising judgement in making provisions for losses and claims.
- In case any executory contract becomes onerous, management should state it, with proper disclosures.
- If the management is unable to assess this due to inadequacy of information, the same should be disclosed to the auditor.
- In case of insurance policies that cover the loss of profits due to business disruptions, the claims can be recognised only if the recovery is virtually certain under Ind AS 37.

Ind AS 10 / AS 4 – Post Balance Sheet events

- Adjustments to assets and liabilities are required to be made for events after the balance sheet date that provide adequate information affecting the conditions existing on the balance sheet date.
- Accordingly, disclosure should be made that such events represent material changes and commitments that affect the financial position of the entity.
- Proper disclosure with measurement and recognition of various items has to be given stating the area of impact of COVID 19.

SA 560 – Subsequent Events

- The auditor shall perform audit procedures designed to obtain sufficient appropriate audit evidence that all events occurring between the date of the financial statements and the date of the auditor's report that require adjustment of, or disclosure in, the financial statements have been identified.
- The auditor is not, however, expected to perform additional audit procedures on matters to which previously applied audit procedures have provided satisfactory conclusions.
- Auditor may rely heavily on alternate audit based on event unfolded subsequent to the year end – e.g. collection of past receivables, sales effected after re-opening, demand for goods, valuation of inventories based on new purchases

AS 1 – Disclosure of Accounting Policies and Going Concern

- The impact of COVID 19 should be considered for an entity's ability to continue as a going concern.
- There may be certain events that indicates that an enterprise ceases to be a going concern (either intends to liquidate or cease trading due to the circumstances present), hence management should evaluate the accounting assumptions while preparing the financials.
- In general advisable to prepare 12-month cash flow to determine where entity stands, review it every quarter, at least. This could be an audit requirement also to test the Going Concern

SA 570 – Going Concern

- The auditor has to consider the implications on the assessment of going concern and viability in the financial report and whether these circumstances will result in prolonged operational disruption which will significantly erode the financial position of the entity or otherwise result in failure.
- Auditors will need to consider whether the threat to liquidity as a result of supply/demand disruption presents a material uncertainty to the going concern status for the 12 months look forward period.
- SA 570 also requires auditors to consider events that may cast significant doubt on the entity's ability to continue as a going concern beyond the period of management's assessment.

Ind AS 1 – Presentation of Financial Statements

- Breach of loan covenants (including classification of liabilities into current and non-current)
 - ✓ Due to COVID-19 there may be instances of breach of loan covenants which may trigger the liability becoming due for payment and liability becoming current.
 - ✓ Such a liability shall not be classified as current, if the lender agreed, not to demand payment as a consequence of the breach.
- Sources of estimation uncertainty :
 - ✓ An entity has to disclose information about the assumptions it makes about the future, and other major sources of estimation of uncertainty at the end of the reporting period. COVID-19 may have created many uncertainties about the likely future scenarios which may affect the estimations of amounts recognised in the balance sheet.
- Comparative information :
 - ✓ Ind AS 1 requires presentation of minimum comparative information such that the users must be able to compare the financial statements in order to identify trends in its financial position and performance and also compare it with financial statements of other entities.
 - ✓ COVID-19 may have affected the financial performance and financial position of entities, hence preparers may consider making adequate disclosures and explanatory notes regarding the impact of COVID-19 on its financial position, performance and cash flows.

Ind AS 110 / AS 21 - Consolidated Financial Statements

- For Consolidated Financial Statements, the financials of the parent and subsidiary are usually drawn up to the same date.
- In any case, the difference between the reporting dates should not be more than 3 months under Ind AS 110.
- In any case, the difference between the reporting dates should not be more than 6 months under AS 21.

SA 600 – Using work of another auditor

- In a case where the parent's auditor is not the auditor of all the components included in the consolidated financial statements, the auditor of the consolidated financial statements should consider the requirements of SA 600 – Using work of another auditor
- Alternatives to obtain sufficient evidence :
 - ✓ Can data be shared cross-border, to allow for principal auditor for review
 - ✓ Can video calls and/or screen sharing software be used to discuss the work with the component auditor
 - ✓ Can the component auditor be asked to complete a detailed questionnaire

Other points for consideration

- Employee benefits
 - ✓ Change in Employment Contract may impact provision for leave encashment / gratuity
 - ✓ While giving data for Actuarial Valuation consider the change in estimate, if any, of Employee increment rate
- General points
 - ✓ Change in estimate or valuation of properties may affect the value of collateral / mortgage with banks and that may in turn affect the borrowing powers and ultimately effect in Revenue / Profit (Loss), infusion of more capital, amendment to borrowing terms / conditions, impact of moratorium availed or to be availed
 - ✓ Financial Statements – management portion – need to include the impact of Covid 19 on their business in general, demand supply scenario, change in interest risk, credit risk, liquidity risk, foreign exchange risk
 - ✓ Possibility of more time to be deployed by the auditors resulting in delay in completion
 - ✓ For Start Ups – impact on business if delay in fund infusion / capital commitment, change in valuation
 - ✓ For Fund – impact of withdrawal / delay in draw down schedule

Internal Control Considerations

- For IFCR, additional considerations that need to be considered as below:
 - ✓ Companies may need to implement new internal controls or modify existing
 - ✓ Evaluate whether any of the controls is not operating effectively on account of absence of concerned person due to illness/quarantine/ working from home/isolation/travel inaccessibility.
 - ✓ Identify alternate controls.
 - ✓ Company's ability to design and implement controls related to selection and application of GAAP

SA 580 – Written Representation

- As per SA 580, the auditor should obtain written representations from the management regarding the various estimates and assessments made by the management.
- The written representations should be exhaustive, containing the occurrence, method of measurement, completeness of transactions recorded
- Auditor needs to assess whether any specific representations may be required to be obtained from the Management in relation to Managements' assessment of impact from the ongoing outbreak of COVID-19 on the financial statements for the year ending March 31, 2020 as well as for the reasonable foreseeable future

SA 701- Reporting of Key Audit Matters

- Key audit matters are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. These are selected from the matters communicated with those charged with governance (TCWG)
- In making this determination, the auditor shall take into account the following :
 - ✓ Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with SA 315.
 - ✓ Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty.
 - ✓ The effect on the audit of significant events or transactions that occurred during the period.
- The auditor should evaluate whether the impact of the disruption caused because of COVID-19 to the operations of the entity, consequential impact on the financial statements would be a key audit matter and if determined so, the auditor would need to report the same along with how the matter was addressed in the audit.

Any Questions?

In case of any further questions, you can write to anyone of us at:

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